

International Finance Transactions— The Pledge of Shares in a German Limited Liability Company

I. Introduction

International finance transactions often involve the granting of a security interest in the shares of a borrower's foreign subsidiary. A corporate entity frequently encountered in such transactions as German subsidiary of the borrower is the limited liability company (*Gesellschaft mit beschränkter Haftung*—GmbH). Generally, in these cases, the grant of a security interest in the GmbH shares is structured as a share pledge by which the borrower pledges its shares in the German subsidiary to the lending party.

The GmbH is frequently encountered in such kinds of transactions as the borrower's German subsidiary because the GmbH is the most commonly used corporate entity in Germany.¹ Originally, the GmbH was designed for small and medium-sized companies with a relatively low share capital and with a small group of shareholders with close ties to one another.² Although this continues to be the predominant use of this corporate form, it is also increasingly found among large business enterprises.³ The GmbH's popularity stems from the fact

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1. Cf. MARCUS LUTTER & PETER HOMMELHOFF, *Einleitung*, in *GMBH-GESETZ, KOMMENTAR*, annot. 1 (14th ed. 1995); see also statistical data given by Götz Hueck, *Einleitung*, in ADOLF BAUMBACH ET AL., *GMBH-GESETZ*, annot. 22-24 (16th ed. 1996) [hereinafter *BAUMBACH & HUECK*].

2. Cf. Götz Hueck, *Einleitung*, in *BAUMBACH & HUECK*, *supra* note 1, at annot. 3.

3. *Id.* at annot. 23-24.

that it is relatively easy to incorporate and administer and that it offers great flexibility in deviating from the statutory model in order to adapt its internal rules to the needs and interests of the enterprise and its shareholders in each particular case.⁴ For this reason, it is also the corporate form most frequently used by foreign investors establishing subsidiaries in Germany.⁵

A typical example of an international finance transaction involving a GmbH as the borrower's German subsidiary is an international syndicated loan in which several parties participate on the borrowing side as well as on the lending side. The lender group usually consists of several international banks which appoint one bank to act as agent for them for the purpose of administering the transaction. The borrower is typically a conglomerate consisting of a parent company and several subsidiaries operating in various jurisdictions. One of these subsidiaries may be a German GmbH. In such transactions, the lending banks often require the borrowing parent company to pledge, in addition to other forms of security, its shares in the GmbH as collateral for the loan.

Another typical scenario in which a pledge of GmbH shares may be used—although more frequently on the domestic⁶ rather than the international level—involves the purchase of a German GmbH by another company by means of a share deal. In such a case, either the acquisition of the GmbH shares may be financed through a bank loan, which in turn is secured by the pledge of the so-acquired shares, or the seller may demand the pledge to secure a delayed purchase price installment.

Despite its frequent use in the above cases, the pledge of GmbH shares presents a number of difficult issues and peculiarities of which the foreign participants in these transactions are often not fully aware. The purpose of this article is to present those issues and peculiarities to the foreign reader from the perspective of the international legal practitioner. The article starts with a discussion of the function, scope, and consequences of a pledge of GmbH shares. It describes which rights are covered by and associated with a pledge of GmbH shares; what consequences this has for the relationship between the pledgor, the pledgee, and the GmbH; and what functions share pledge can fulfill. The following section discusses several limitations and pitfalls associated with a share pledge, which may cause severe problems in international finance transactions. The final section describes the mechanics of effecting a share pledge with particular emphasis on the issues raised in the context of crossborder financing operations.

4. *Id.* at annot. 25.

5. LUTTER & HOMMELHOFF, *supra* note 1, at annot. 19.

6. For domestic cases, see Johannes Kolkmann, *Die Verpfändung von Geschäftsanteilen und die Sicherung des Pfandrechts (Einziehung, Zusammenlegung, Auflösung)*, MITTEILUNGEN DER RHEINISCHEN NOTARKAMMER 1, 4 (1992).

II. Function, Scope, and Consequences

A. FUNCTION OF SHARE PLEDGE

The collateral provided by the share pledge often has only limited economic value.⁷ Contrary to other forms of security, such as an assignment of the GmbH's accounts receivable or a security transfer of title to the GmbH's equipment and inventory, the share pledge does not provide the lending party with direct access to the GmbH's assets. Rather, in its bare form, it gives the pledgee only the right to sell the shares by way of public auction. At such auction, for lack of other willing bidders, these shares will often be bought by the lending party itself, be it directly or through an affiliated investment company.

Still, the share pledge may serve various important functions. On the one hand, it may be a substitute for other forms of security, which although they would give the lender more direct access to the GmbH's assets, they are not available for various reasons. For example, other forms of collateral may not be available because they have already been used to secure prior bank loans extended directly to the GmbH. Also, they may not be available because their grant would violate the rules on capital preservation of the German Act concerning Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*—GmbHG or GmbH-Act).⁸ Under these rules, which are considered a cornerstone of German limited liability company law, those corporate assets required to preserve the stated capital of the GmbH must not be turned over to the company's shareholders.⁹ These rules are applied not only in the context of straightforward distributions to shareholders but also in the context of other transactions that may be regarded as a constructive repayment of the share capital to the shareholder, such as where the GmbH provides security for the debts of a shareholder.¹⁰ Therefore, if the collateral granted by the GmbH for a loan taken out by its parent company were to reduce the net worth of the GmbH below its stated capital, the realization of such collateral would be prohibited under the rules on capital preservation. In such a case, instead of the GmbH providing collateral for the loan granted to its parent, such borrower itself may pledge its shares in the GmbH to secure the loan.

7. *Id.* at 2.

8. See Frank Wenzel, *Die Vereinbarkeit von Sicherheitenbestellungen mit gesellschaftsrechtlichen Kapitalerhaltungsvorschriften*, WIRTSCHAFTSRECHTLICHE BERATUNG 10 (1996); Martin Peltzer, *Besicherte Darlehen von Dritten an Konzerngesellschaften und Kapitalerhaltungsvorschriften*, GMBH-RUNDSCHAU [GMBHR] 15 (1995); Wolfgang Schön, *Kreditbesicherung durch abhängige Kapitalgesellschaften*, ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT [ZHR] 351 (1995); Herbert Messer, *Kreditbesicherung im Konzern*, ZHR 375 (1995); Jürgen Sonnenhol & Wolfgang Groß, *Besicherung von Krediten Dritter an Konzernunternehmen*, ZHR 388 (1995).

9. See §§ 30-31 GESETZ BETREFFEND DIE GESELLSCHAFTEN MIT BESCHRÄNKTER HAFTUNG [GMBHG].

10. Wenzel, *supra* note 8, at 11-12; Sonnenhol & Groß, *supra* note 8, at 395-401.

The pledge of shares may also be used as a substitute for other forms of security, which may be too complicated or expensive to provide or administer in the given case. For example, assigning the accounts receivable of a GmbH or transferring the ownership with regard to its equipment or inventory requires rather detailed documentation and close and continuous subsequent supervision by the lending bank of the accounts and chattel covered by the respective collateral. In the case of an international syndicated loan agreement involving a German GmbH as the borrower's subsidiary, the administrative agent of the lending banks is often a U.S. bank. This U.S. bank either may not have the logistical set-up for, or may prefer to avoid the costs associated with, closely supervising the day-to-day development of the accounts receivable and the inventory of the borrower's German subsidiary. In these cases, the pledge of the GmbH shares offers a more convenient alternative for securing the loan.

Finally, the purpose of a share pledge in the context of an international syndicated loan may simply be to provide further security in addition to other forms of collateral granted to the lending banks. As such, the share pledge may be used, for example, for closing potential loopholes left by the other security in order to protect the lenders against disadvantageous (and in the worst case even fraudulent) transfers of the borrowed money within the borrowing conglomerate.

B. BASIC LEGAL STRUCTURE OF SHARE PLEDGE

The shares of a GmbH are pledged by an agreement between the pledgor and the pledgee, which requires the form of a notarial deed.¹¹ As to the applicable law, it is customary in legal practice to subject the pledge agreement to German law, since it refers to the shares of a German GmbH.¹² Under German law, from

11. See § 1274 subsec. 1 cl. 1 BÜRGERLICHES GESETZBUCH [BGB] (German Civil Code), § 15 subsec. 3 cl. 1 GMBHG. There are no specific statutory provisions in German law on the pledge of GmbH shares. Instead this subject matter is regulated by the general provisions of the German Civil Code concerning the pledge of rights (§§ 1273-1296 BGB) in connection with the provisions of the Act concerning Limited Liability Companies that deal with the transfer of GmbH shares (§§ 15-17 GMBHG).

12. Strictly speaking, under German conflict-of-law rules, a choice-of-law by the parties is possible only for the security agreement (*see* main text), since only this part of the share pledge agreement is subject to the conflict-of-law rules governing contracts. *See* Carsten Thomas Ebenroth, *Nach Art. 10 EGBGB, in 7 MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH, EINFÜHRUNGSGESETZ ZUM BÜRGERLICHEN GESETZBUCH, INTERNATIONALES PRIVATRECHT*, annot. 308 (Kurt Rebmann & Franz Jürgen Säcker eds., 2d ed. 1990) [hereinafter 7 MÜNCHENER KOMMENTAR]. The share pledge as such, on the other hand, is subject to the law governing the company the shares of which are being pledged. *Id.* at annot. 307; Bernhard Großfeld, *Internationales Gesellschaftsrecht, in HERMANN AMANN ET AL., J. VON STAUDINGERS KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH*, annot. 320 (13th ed. 1993) [hereinafter Großfeld, *Internationales Gesellschaftsrecht*]. Since, in the above context, this company is usually a German GmbH which was founded and has its main place of business in Germany, German law is applicable to the share pledge according to German and U.S. conflict-of-law rules. *See* GERHARD KEGEL, *INTERNATIONALES PRIVATRECHT* 414-15 (7th ed. 1995); EUGENE F. SCOLES & PETER HAY, *CONFLICT OF LAWS* 913 (2d ed. 1992).

a strict legal point of view, the legal instrument containing the share pledge consists of two distinct agreements: first, the share pledge agreement,¹³ and second, the security agreement, which regulates the fiduciary obligations extending between the pledgor and the pledgee in connection with the share pledge.¹⁴ The security agreement is of particular importance because German law allows the parties only relatively little leeway to modify the terms of the share pledge. Therefore, the security agreement usually contains detailed rules regulating the fiduciary relationship between the parties, such as a description of the security purpose of the pledge, representations and warranties, duties of notification, etc.

Usually, the share pledge creates a bilateral contractual relationship between two parties, with the pledgor on the one side and the pledgee on the other side. In international syndicated loan agreements, the pledgee often comprises several banks, one of which is specifically designated as the administrative agent. Because of the accessory nature of the pledge, which will be described in further detail below, the pledgee and the party who is lending the secured loan have to be identical.¹⁵ Therefore, the shares always have to be pledged to those banks that are actually granting the loan to the borrower. On the other side, however, the borrower and pledgor do not need to be identical for the pledge to become effective.¹⁶ Consequently, although this occurs only rarely in legal practice, a third party may pledge its shares in a GmbH in favor of the borrower. In that case, the pledge creates a trilateral relationship between the pledgor, the debtor (borrower), and the pledgee.

The share pledge by itself does not transfer full title to the shares. Rather, it creates a lien on the shares, which in its bare form, gives the pledgee only the right, upon an event of default, to realize this security by way of selling the shares on his account at a public auction.¹⁷ Additionally, if pledgor and pledgee so agree, the pledge can also extend to the shareholder dividend rights.¹⁸ Further, although the share pledge by itself does not include the shareholder's voting rights, the pledgor can authorize the pledgee to exercise his voting rights on his behalf. However, any such extension of the rights granted to the pledgee under the pledge agreement, which assimilates the legal position of the pledgee vis-à-vis the GmbH to that of an outright shareholder, may cause problems for the pledgee with regard to the rules of equity-replacing shareholder loans as will be discussed in detail below.¹⁹

13. In the German legal practice, this part is called *Verpfändung* (pledge).

14. In the German legal practice, this part is called *Sicherungsvertrag* (security agreement).

15. Peter Bassenge, *Überblick vor § 1204 BGB*, in OTTO PALANDT ET AL., *BÜRGERLICHES GESETZBUCH*, annot. 3 (56th ed. 1997) [hereinafter PALANDT, BGB].

16. *Id.*

17. See § 1277 BGB.

18. See §§ 1273, 1213 subsec. 1 BGB.

19. See *infra* part III.C.

C. REALIZATION OF THE PLEDGE

The principal purpose of the share pledge is to give the pledgee the right to avail himself of the economic value embodied in the shares in the event of a default by the debtor.²⁰ German law offers the pledgee a limited number of options in order to realize the pledge.

Generally, the pledgee has only the right to have the pledged shares sold on his account at a public auction in accordance with the general rules of German law on the enforcement of judgments.²¹ Under these rules, the pledgee has to obtain a prior court judgment enforceable against the pledgor holding that the pledgee is entitled to seek satisfaction out of the pledge for the secured money claims. Based on this judgment, the pledgee then needs to have the court order an attachment of the shares after which they can be sold at a public auction.²² Under this cumbersome procedure, the only advantage of the share pledge for the pledgee is to grant priority over other creditors on whose behalf the shares might have been attached by court order after the initial share pledge.²³

The parties have only relatively limited liberty to deviate from this procedure. For example, the pledgor may waive the requirement that the pledgee has to obtain a prior judgment and the attachment of the shares before they can be sold.²⁴ In international finance transactions, such waiver is customarily included in the share pledge agreement in order to facilitate the realization of the pledge.²⁵ However, the pledgor is generally not allowed to waive the requirement that the shares have to be sold at a public auction. This requirement can only be waived after the pledge has matured, *i.e.*, when the pledge has become due so that the pledgee is entitled to realize the pledge.²⁶

Therefore, it is not possible for the parties to arrange in the original share pledge agreement that the shares be sold by way of a private sale at maturity of the pledge.²⁷ The same applies to such contractual arrangements known as

20. See Heinz Rowedder, § 15 *GmbHG*, in HEINZ ROWEDDER ET AL., *GESETZ BETREFFEND DIE GESELLSCHAFTEN MIT BESCHRÄNKTER HAFTUNG (GmbHG)*, annot. 45 (3d ed. 1997).

21. See § 1277 BGB.

22. Jürgen Damrau, § 1277 *BGB*, in 6 *MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH, SACHENRECHT*, annot. 2-4 (Kurt Rebmann et al. eds., 3d ed. 1997) [hereinafter 6 *MÜNCHENER KOMMENTAR*]; Kolkman, *supra* note 6, at 12.

23. See Peter Bassenge, § 1277 *BGB*, in PALANDT, *BGB*, *supra* note 15, at annot. 2.

24. See § 1277 BGB.

25. In such international transactions, the share pledge agreement usually also contains a clause in which the pledgor appoints an agent for the receipt of service of process in German courts in order to accelerate future court proceedings which may become necessary in connection with the enforcement of the share pledge.

26. See §§ 1277, 1245 subsec. 2, 1235 BGB.

27. Damrau, § 1277 *BGB*, in 6 *MÜNCHENER KOMMENTAR*, *supra* note 22, at annot. 5; Jörg Rodewald, *Überlegungen im Zusammenhang mit der Verpfändung von GmbH-Anteilen*, *GMBHR* (1995), 418, 421. A private sale of the pledged shares in violation of these rules would be illegal so that no effective title to the shares would pass to the purchaser. See §§ 1273 subsec. 2 cl. 1, 1243 subsec. 1 BGB.

"forfeiture clauses,"²⁸ according to which full title to the pledged shares is to pass automatically to the pledgee if the secured loan is not repaid in full when due.²⁹ Both kinds of arrangements can only be made after the pledge has matured.³⁰

Numerous consequences arise for the legal practice of international finance transactions. Under German statutory law, the pledge matures at the time when all or part of the secured loan becomes due and payable³¹ and the parties are not permitted to advance the maturity of the pledge to an earlier date.³² In syndicated loan agreements, the maturity of the secured loan as a whole is usually made dependent on the occurrence of certain events of default as defined in the loan agreement. Typically, the loan agreement defines events of default as, for example, (i) default by the borrower in repaying a specified part of the principal or interest of the loan that has become due, (ii) proof that a representation or warranty made by the borrower in the credit agreement is incorrect, (iii) violation by the borrower of a negative covenant undertaken in the credit agreement, or (iv) commencement of bankruptcy or other similar proceedings against the borrower. Further, the loan agreement typically authorizes the agent of the lending banks to declare the entire outstanding principal and interest of the loan due and payable at the occurrence of such event of default. Consequently, since German statutory law links the maturity of the pledge to the maturity of all or part of the secured loan, the pledgor and pledgee may agree on a private sale of the pledged shares or on a "forfeiture clause" only (i) after part of the secured loan has become due or (ii) after an event of default as defined in the loan agreement has occurred and the banks' agent thereupon has declared the entire outstanding loan due and payable.

Obviously, the realization of the pledge by way of a public auction may entail severe disadvantages for all parties. For the GmbH itself, a public auction will create unwelcomed publicity.³³ Also, no established market generally exists for the shares of a GmbH.³⁴ Since a GmbH usually has only a small number of shareholders and since the transfer of GmbH shares must be done by way of notarial deed,³⁵ these shares are generally not fungible.³⁶ Therefore, it is very unlikely that a buyer, willing to acquire these shares at a price that corresponds to their full economic value, will be found.³⁷ This means that the pledgee will

28. In the German legal practice, this kind of clause is called *Verfallklausel* (forfeiture clause).

29. Damrau, § 1277 BGB, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 5; see §§ 1277, 1229 BGB.

30. Damrau, § 1277 BGB, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 5.

31. §§ 1273 subsec. 2 cl. 1, 1228 subsec. 2 cl. 1 BGB.

32. Damrau, § 1228 BGB, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 10; Peter Bassenge, § 1228 BGB, in PALANDT, BGB, *supra* note 15, at annot. 2.

33. Klaus Müller, *Die Verpfändung von GmbH-Anteilen*, GMBHR (1969), 4, 59.

34. Kolkmann, *supra* note 6, at 4.

35. See § 15 subsec. 3 cl. 1 GMBHG.

36. Kolkmann, *supra* note 6, at 4.

37. Rodewald, *supra* note 27, at 421.

usually get only partial satisfaction for his outstanding claims against the debtor through the realization of the pledge and that the debtor in turn will not be fully released from his debts. If no buyer can be found at all, the pledgee may be forced to acquire the pledged shares himself and to credit them at their present value against the outstanding debts of the defaulting debtor.³⁸ In either case, the determination of the present value of the shares may be difficult thereby causing disagreement between pledgor and pledgee because of the usual problems associated with evaluating an operating enterprise. Therefore, it may be useful to include a clause in the share pledge agreement providing for a mechanism (*e.g.*, arbitration) for determining the value of the shares if the pledgor and the pledgee cannot agree on this issue.³⁹

D. DIVIDEND RIGHTS AND RIGHTS TO LIQUIDATION PROCEEDS

Unless otherwise specified by the parties, the share pledge gives the pledgee merely the right to have the shares sold on his account and does not entitle him to the shareholder's dividend rights.⁴⁰ However, the parties may extend the share pledge to cover these rights if they so decide.⁴¹ In that case, the pledgee will be entitled to claim the dividends directly from the GmbH only after having notified the company about the pledge.⁴² Unless otherwise specified by the parties, any such dividend payments made by the company to the pledgee will be applied first to the accrued interest and then to the secured principal.⁴³

The validity of the share pledge is not affected if the GmbH is dissolved.⁴⁴ When the GmbH is dissolved, it changes its character from an operating company to a company in liquidation.⁴⁵ Accordingly, the shareholder's dividend rights are replaced by his rights to his share in the company's liquidation proceeds.⁴⁶ Although the shareholder's dividend rights are covered by the share pledge, only if the parties specifically so agree, the shareholder's rights to his share in the liquidation proceeds are covered by the share pledge by operation of law, *i.e.*, without a specific agreement.⁴⁷

38. See Kolkman, *supra* note 6, at 4; Müller, *supra* note 33, at 59.

39. For more details, see Rodewald, *supra* note 27, at 422.

40. Heinz Winter, § 15 *GmbHG*, in 1 FRANZ SCHOLZ ET AL., KOMMENTAR ZUM GMBH-GESETZ, annot. 160 (8th ed. 1993) [hereinafter SCHOLZ]; Müller, *supra* note 33, at 57.

41. See §§ 1273 subsec. 2 cl. 1, 1213 subsec. 1 BGB. This kind of share pledge is called *Nutzungspfandrecht* (antichresis).

42. § 1274 subsec. 1 BGB, § 16 subsec. 1 GmbHG; Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 160.

43. §§ 1273 subsec. 2 cl. 1, 1214 subsec. 2 and 3 BGB.

44. Kolkman, *supra* note 6, at 7; Müller, *supra* note 33, at 36.

45. Joachim Schulze-Osterloh, § 60 *GmbHG*, in BAUMBACH & HUECK, *supra* note 1, at annot. 8.

46. Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 162; Müller, *supra* note 33, at 36.

47. Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 162; Götz Hueck, § 15 *GmbHG*, in BAUMBACH & HUECK, *supra* note 1, at annot. 50; Jürg Zutt, *Anhang § 15 GmbHG*, in MAX HACHENBURG ET AL., GESETZ BETREFFEND DIE GESELLSCHAFTEN MIT BESCHRÄNKTER HAFTUNG

Such substitution by operation of law also applies in all other cases where the pledgee's shares are replaced by similar compensation rights. For example, if the company decides to redeem the shares⁴⁸ or to otherwise exclude the shareholder⁴⁹ or if the shareholder himself decides to withdraw from the company,⁵⁰ the shareholder is entitled to receive compensation for his shares.⁵¹ By operation of law, these compensation rights are covered by the share pledge.⁵²

E. VOTING AND OTHER CONTROL AND MANAGEMENT RIGHTS

The share pledge does not extend to the pledgor's shareholder voting rights and other control and management rights. Therefore, these rights continue to vest in the pledgor after the pledge.⁵³ Generally, there exists no statutory requirement that the pledgor has to obtain the pledgee's consent for exercising these rights.⁵⁴ Consequently, the pledgor can participate and vote in shareholder meetings; exercise his control rights under §§ 50, 51a, and 51b GmbH-Act;⁵⁵ and file a suit for the annulment of a shareholder vote without having to obtain the pledgee's prior consent.⁵⁶ Under statutory law, the pledgor is generally not required to obtain the pledgee's consent for exercising his shareholder rights even if their use results in the amendment or destruction of the pledged shares.⁵⁷

(GmbHG), GROSSKOMMENTAR, annot. 46 (8th ed. 1992) [hereinafter HACHENBURG]; Müller, *supra* note 33, at 36. *But see* Kolkmann, *supra* note 6, at 7, according to whom the right to the liquidation proceeds would need to be pledged separately.

48. According to § 34 GmbHG, a redemption of shares is only permitted if authorized in the company's articles of association or if agreed to by the shareholder.

49. An exclusion of the shareholder is permitted only if authorized by the company's articles of association or if the shareholder is excluded for cause. Götz Hueck, *Anhang § 34 GmbHG*, in BAUMBACH & HUECK, *supra* note 1, at annot. 2.

50. If the company's articles of association do not provide for a right of withdrawal, the shareholder can only withdraw for cause. *Id.* at annot. 15.

51. *Id.* at annot. 11, 21; Götz Hueck, § 34 GmbHG, in BAUMBACH & HUECK, *supra* note 1, at annot. 17a.

52. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 46; Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 164.

53. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44; Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 158; Damrau, § 1274 BGB, in 6 Münchener Kommentar, *supra* note 22, at annot. 60.

54. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44.

55. Under § 50 GmbHG, a minority shareholder with at least ten percent of the shares has the right to call shareholder meetings. Under §§ 51a-51b GmbHG, all shareholders have the right to inspect the company's books and to demand information from the company's managing directors.

56. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44.

57. Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 158; Rodewald, *supra* note 27, at 419. The provision of § 1276 BGB, which normally requires the consent of the pledgee in any action by the pledgor that results in the destruction or amendment of the pledged right, is not applicable in the context of shareholder votes. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44. However, according to the predominant opinion among German commentators, there are two exceptions to this rule: If the company's articles of association grant the shareholder the right to terminate his shareholder membership without cause, he can exercise this right only with the consent of the pledgee. The same applies if the pledgor agrees according to § 34

Consequently, the pledgor does not need the pledgee's consent for filing a claim for the dissolution of the GmbH, for terminating his shareholder position for cause, or for surrendering his shareholding according to § 27 GmbH-Act.⁵⁸ According to German commentators, these rights are part of the unalienable core of shareholder rights and therefore, their exercise by the pledgor should not, by operation of law, be tied to the requirement of a third party's consent.⁵⁹ Even if the exercise of these rights by the pledgor resulted in the cancellation of the pledged shares, these acts would still be valid vis-à-vis the pledgee.⁶⁰ The same applies to all other acts by the company that cancel the pledgor's shares.⁶¹ In both cases, the pledgee is entitled to the compensation claims mentioned above which become due to the pledgor with the cancellation of the shares.⁶²

Even though the pledgor is not required under statutory law to obtain the pledgee's prior consent for exercising his shareholder rights in a way that may be harmful to the interests of the pledgee, the question arises whether under implied contractual duties arising from the security agreement, the pledgor is obliged to refrain from any act that may negatively affect the pledged shares.⁶³ However, any such implied contractual duty is subject to the qualification that the fiduciary duties of the pledgor vis-à-vis the company, in his capacity as shareholder, have priority in time as well as in importance over his contractual obligations towards the pledgee.⁶⁴ The pledgor is not required to exercise his shareholder rights solely in the interest of the pledgee. He also has to give consideration to the interests of the company and he may even give consideration to his own legitimate interests.⁶⁵ Therefore, the pledgor would only be violating his implied duties under the security agreement vis-à-vis the pledgee if he exercised his shareholder rights in a manner harmful to the pledgee in spite of the existence of other alternatives which would have been equally beneficial to the company.⁶⁶

GMBHG with the other shareholders' decisions to exclude him from the company and to redeem his shares. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44; see also Heinz Winter, *supra*, at annot. 169.

58. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44; Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 169; Götz Hueck, § 15 GmbHG, in BAUMBACH & HUECK, *supra* note 1, at annot. 49; see also Damrau, § 1274 BGB, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 62-64; Müller, *supra* note 33, at 7-9. Section 27 GmbHG gives a shareholder who has paid in his full initial share contribution and who is asked to make supplementary capital contributions the right to surrender his shareholder membership under certain circumstances if he is not willing to make these additional payments.

59. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44.

60. *Id.*

61. Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 169.

62. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44.

63. See Kolkmann, *supra* note 6, at 8; Müller, *supra* note 33, at 34.

64. Kolkmann, *supra* note 6, at 8.

65. Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 168; Müller, *supra* note 33, at 7.

66. Kolkmann, *supra* note 6, at 8-9; Müller, *supra* note 33, at 34; see also Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 168.

Usually, it will be difficult for the pledgee to prove that such other alternatives existed.⁶⁷ Consequently, in legal practice, the pledgee will generally be successful in claiming a violation of the pledgor's implied duties under the security agreement only if the pledgor openly acted with the intent to harm the pledgee.⁶⁸

Because of the vagueness and limited scope of these implied duties, it is important for the pledgee that he and the pledgor specifically agree in the security agreement on how to give the pledgee some form of control over the pledgor's use of his voting rights and other control and management rights. However, such contractual arrangements are subject to certain limitations under German statutory law. For example, the pledgor can grant a power of attorney to the pledgee to exercise his voting rights on his behalf.⁶⁹ Such power of attorney may even be granted irrevocably⁷⁰ but not in such manner as to exclude the pledgor vis-à-vis the company from exercising his shareholder rights himself.⁷¹ Similarly, it is not possible for the pledgor to transfer his voting rights and other control and management rights to the pledgee since such transfer is considered to violate the important principle of German corporate law that such shareholder rights must not be separated from the shareholder holding itself.⁷²

On the other hand, the share pledge security agreement may contain certain undertakings of the pledgor by which he agrees to not exercise his voting and other participation rights in a manner that is incompatible with the pledgee's legitimate interests.⁷³ Any such agreement has to take into consideration, however, that the fiduciary duties of the pledgor vis-à-vis the company have priority over his contractual obligations towards the pledgee.⁷⁴ Therefore, the security agreement has to carefully balance the interests of the pledgee, the pledgor, and the company. Consequently, it should submit the pledgor's shareholder rights to varying degrees of supervision and participation by the pledgee depending on how much the pledgee's interests could be adversely affected by the exercise of these rights and to what extent these rights belong to the unalienable core of the pledgor's shareholder rights.⁷⁵ The most flexible clause for this purpose would

67. According to Kolkman, *supra* note 6, at 9, the burden of proof for this issue is carried by the pledgee.

68. Kolkman, *supra* note 6, at 9; see also Müller, *supra* note 33, at 34.

69. Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 159; Rodewald, *supra* note 27, at 419.

70. Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 159; Jürg Zutt, *Anhang § 15 GmbHG, in HACHENBURG*, *supra* note 47, at annot. 34, 44a; Müller, *supra* note 33, at 10. Even an irrevocable power of attorney, however, may be terminated for cause. *Id.*

71. Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 159; Müller, *supra* note 33, at 10-11.

72. Götz Hueck, § 15 GmbHG, in BAUMBACH & HUECK, *supra* note 1, at annot. 49; Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 159; Müller, *supra* note 33, at 9-11. This principle is called *Abspaltungsverbot*.

73. Rodewald, *supra* note 27, at 419.

74. Kolkman, *supra* note 6, at 8.

75. Rodewald, *supra* note 27, at 419-20. See also Müller, *supra* note 33, at 7.

be one in which the pledgor agrees to refrain from any acts which would cause the pledged shares to cease to exist or to become encumbered in any way other than agreed by the pledgee, while the pledgee agrees not to unreasonably withhold or delay his consent with due regard to the legitimate interests of the pledgor.⁷⁶ Further, the pledgor may agree in the security agreement to notify the pledgee in a timely manner of the date, place, and agenda of proposed shareholder meetings and to exercise his voting rights and other management rights only after due notification of the pledgee.⁷⁷

A violation of the obligations undertaken by the pledgor in the security agreement vis-à-vis the pledgee usually gives rise only to damage claims of the latter against the pledgor. Generally, such violation does not invalidate the respective shareholder vote or other corporate act by which the security agreement is violated.⁷⁸ Only under exceptional circumstances, if the pledgor and the company's other shareholders have acted jointly and willfully together to the disadvantage of the pledgee, may such corporate act be considered invalid under the theory of collusion.⁷⁹

III. Limitations and Pitfalls

The German law on share pledges presents several important limitations and dangers of which foreign legal practitioners are often not fully aware and which, therefore, may create serious problems in international transactions. Some of these risks shall be discussed in the following paragraphs.

A. NO REGISTRATION AND NO BONA FIDE CREATION OR RANK OF PLEDGE

Contrary to other legal systems, German law does not provide for registration of share ownership or encumbrance of shares. Therefore, it is difficult for the pledgee to ascertain whether the pledgor is in fact the true and unencumbered owner of the pledged shares. Moreover, German law does not provide for a bona fide creation of a share pledge⁸⁰ or a bona fide acquisition of a specific rank of the pledge.⁸¹ Consequently, if the shares purported to be pledged do not exist or have been previously transferred to a third party, the pledgee does not acquire any security right with regard to these shares even if he acted in good faith. The same applies to the rank of the pledge so that if the shares had been previously

76. See Rodewald, *supra* note 27, at 419-20.

77. Kolkman, *supra* note 6, at 11.

78. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44; Heinz Winter, *§ 15 GmbHG*, in SCHOLZ, *supra* note 40, at annot. 168.

79. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 44; Heinz Winter, *§ 15 GmbHG*, in SCHOLZ, *supra* note 40, at annot. 168.

80. Damrau, *§ 1274 BGB*, in 6 MÜNCHENER KOMMENTAR, *supra* note 59, at annot. 27h; Kolkman, *supra* note 6, at 2-3.

81. Damrau, *§ 1273 BGB*, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 7.

encumbered for the benefit of a third party, the security right acquired by the pledgee in the later transaction ranks behind the existing pledge.

Under this disadvantageous legal regime, the pledgee has only two options to protect his interests. First, the pledgor should be asked to represent and warrant in the share pledge agreement that he is the true and unencumbered owner of the pledged shares. Second, due diligence should be conducted with regard to ownership of the pledgor and the existence of any previous encumbrances. For this purpose, among other things, the company whose shares are to be pledged should be asked to confirm that to its knowledge the shares have not been previously encumbered. Although the notification of the company is not a legal requirement for the share pledge to become effective under German statutory law,⁸² it is customary and practical⁸³ to notify the company of a share pledge so that the company will generally be able to provide information about any previous pledge.

B. ACCESSORY NATURE OF PLEDGE

1. *In General*

Under German law, the share pledge is a security instrument of a strictly accessory nature.⁸⁴ This means that the effectiveness of the share pledge is continuously dependent on the existence of the secured obligation. Consequently, the share pledge becomes legally effective only if, to the extent that, and as long as the underlying obligations exist.⁸⁵ The accessory nature of the share pledge further entails that the owners of the secured claims and the pledgees must be identical.⁸⁶ The accessory nature of the share pledge is mandatory and therefore cannot be waived or modified by the parties.⁸⁷ Evidently, these restrictions may have significant implications for international finance transactions.

2. *Creation of Pledge*

In the typical scenario of international syndicated loans, the lender group consists of several international banks, which appoint one bank to act as administrative agent for such consortium. Usually, the collateral securing the loan (*e.g.*, mort-

82. Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 155; Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 42; Damrau, § 1274 *BGB*, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 55.

83. For details see *infra* part IVB.

84. Damrau, § 1204 *BGB*, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 15.

85. Peter Bassenge, *Einführung vor § 1204 BGB*, in PALANDT, *BGB*, *supra* note 15, at annot. 2; see Kolkmann, *supra* note 6, at 3. However, a share pledge may also be used to secure future obligations or obligations which are subject to a suspensive condition. §§ 1273 subsec. 2, 1204 subsec. 2 *BGB*.

86. Peter Bassenge, *Einführung vor § 1204 BGB*, in PALANDT, *BGB*, *supra* note 15, at annot. 3.

87. JÜRGEN F. BAUR & ROLF STÜRNER, *LEHRBUCH DES SACHENRECHTS* 587 (16th ed. 1992).

gages, assignment of accounts receivable, transfer of title to equipment and inventory, etc.) is provided by the borrower to the lenders' agent who enters into the respective agreements in its own name and for the account of the lender group. The purpose of the agent in these transactions, acting under its own name and in a trustee capacity, is to facilitate the administration of the collateral and its realization in case of a default by the borrower.

This legal practice, however, is incompatible with the requirements of a German share pledge. Because of its accessory nature, the owner of the secured claim and the pledgee have to be identical and the share pledge only comes into existence if and to the extent that the pledgee is also the owner of the secured obligations.⁸⁸ Therefore, if the lenders' agent enters into the share pledge agreement in its own name, the share pledge will be valid only if and insofar as the lenders' agent itself is lending money to the pledgor. Consequently, if the lenders' agent has merely administrative functions and does not grant any part of the loan itself, the share pledge will be totally void. Otherwise only the part of the loan given by the lenders' agent in its individual capacity as a lender would be secured by the share pledge.

To avoid these consequences, the lenders' agent has to enter into the share pledge agreement not only in its own name but also in the name of the entire lender group for which the lenders' agent needs to be duly authorized. In international finance transactions, this authorization is usually provided for in the document containing the syndicated loan agreement. For practical purposes, the lenders' agent often delegates authority to German counsel (or other representatives present in Germany) for executing the share pledge agreement before a German notary public.⁸⁹ Usually, a parallel power of attorney is granted to German counsel by the pledgor so that eventually all parties to the transaction are represented at the notarization by German counsel.

Drafting the respective powers of attorney granted to the lenders' agent and to German counsel requires careful attention. The authority conferred by the power of attorney needs to be wide enough to enable the parties to react in a flexible and swift manner to unexpected events during the subsequent administration of the share pledge. Therefore, the power of attorney granted to the lenders' agent should confer not only the power to enter into the share pledge agreement, but also to subsequently amend and perhaps even cancel it if and insofar as necessary. Also, the power of attorney granted to the lenders' agent has to include the power to delegate authority to German counsel.

88. Peter Bassenge, *Einführung vor § 1204 BGB*, in PALANDT, BGB, *supra* note 15, at annot. 2-3.

89. The share pledge agreement has to be executed in the form of a notarial deed. *See* § 1274 subsec. 1 cl. 1 BGB, § 15 subsec. 3 cl. 1 GmbHG.

3. Assignment of Secured Obligation

Another important aspect of the accessory nature of the share pledge is that the secured obligation and the share pledge can only be assigned together.⁹⁰ Any assignment of the secured claim automatically includes a transfer of the share pledge to the assignee.⁹¹ If only part of the secured claim is assigned, the share pledge is transferred to the assignee by operation of law to the extent it secures the assigned obligation. The share pledge vesting in the assignee thereupon will rank *pari passu* with the remaining share pledge of the assignor.⁹²

Consequently, if one of the participating lending banks assigns part of the secured loan to a third party, the respective part of the share pledge will automatically transfer to the assignee and thereupon will rank *pari passu* with the remaining share pledge of the lender group. In order for the lenders' agent to be able to subsequently change the share pledge agreement with effect for the entire share pledge, *i.e.*, including the part which is now vesting in the assignee, the assignee should grant a respective power of attorney to the lenders' agent in the assignment agreement. As explained above, this power of attorney should, for practical purposes, also include the power to delegate authority to German counsel.

In principle, if the assignor and assignee decide that the share pledge shall not be transferred together with the assigned obligation, the share pledge ceases to exist as soon as the assignment of the secured obligation becomes effective.⁹³ However, if the assigned claim is part of a syndicated loan that remains in effect between the borrower and the rest of the lender group, the share pledge stays effective as between the pledgor and the rest of the lender group (*i.e.*, excluding the assignor).⁹⁴

4. Repayment of Secured Obligation under Revolving Loan

Because of its accessory nature, the share pledge is effective only as long as the secured obligation does in fact exist.⁹⁵ Therefore, it automatically ceases to exist as soon as the secured obligation is fully repaid.⁹⁶ The share pledge does

90. Damrau, § 1250 BGB, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 1. The share pledge can be assigned only by way of assignment of the secured obligation. § 1250 subsec. 1 cl. 2 BGB. There exists no particular form requirement for the assignment of the share pledge. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 50.

91. § 1250 subsec. 1 cl. 1 BGB.

92. Peter Bassenge, § 1250 BGB, in PALANDT, BGB, *supra* note 15, at annot. 1; Damrau, § 1250 BGB, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 2.

93. § 1250 subsec. 2 BGB.

94. Cf. Peter Bassenge, § 1250 BGB, in PALANDT, BGB, *supra* note 15, at annot. 2; Damrau, § 1250 BGB, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 5; BAUR & STÜRNER, *supra* note 84, at 601.

95. Peter Bassenge, *Einführung vor § 1204 BGB*, in PALANDT, BGB, *supra* note 15, at annot. 2.

96. § 1252 BGB.

not expire, however, if the secured obligation is only partially repaid, but remains effective until the full and final repayment of the entire secured obligation.⁹⁷ Accordingly, if the share pledge is intended to secure all present and future⁹⁸ claims arising under a revolving loan agreement, the share pledge does not expire until the entire loan agreement expires.⁹⁹

Consequently, careful attention should be paid to drafting the share pledge agreement in order to prevent a premature extinguishment of the share pledge in the case that the borrower is temporarily not drawing any funds under the credit facility. For this purpose, the share pledge agreement should provide that the share pledge shall serve the purpose of securing the full and final satisfaction of all obligations of the borrower arising under the respective credit agreement and that it shall remain effective until the complete and final satisfaction of all these obligations.

5. *Amendment and Novation of Loan Agreement*

Since the share pledge is effective only as long as the secured obligation exists, difficult issues may arise in connection with refinancing the secured loan. Because of the accessory nature of the share pledge, it is not possible to exchange the secured claim by way of novation against a new obligation while retaining the original share pledge. If the obligation, which was originally secured by the share pledge, is terminated by mutual agreement of the parties and a new obligation is created, the original share pledge expires.¹⁰⁰ The parties then have to agree on a new share pledge to secure the new obligation. This new share pledge will rank behind other pledges which may have been created in the meantime.¹⁰¹ German law does not allow the parties to agree on maintaining the rank of the original share pledge for the new share pledge if the secured claim is exchanged by a new obligation.¹⁰²

These problems can only be avoided by structuring the refinancing as an amendment of the original loan rather than a novation. An amendment of the loan agreement leaves the original share pledge intact thereby retaining its rank position. Banks participating in syndicated loan agreements involving the pledge of GmbH-shares are generally aware of these problems and therefore are willing to structure the refinancing accordingly. Also, refinancing agreements usually contain a clause providing that the parties intend to merely

97. Hans-Peter Benckendorff, *Vertragliche und gesetzliche Pfandrechte an beweglichen Sachen und an Rechten und Zurückbehaltungsrechte*, in 2 *BANKRECHT UND BANKPRAXIS*, annot. 4/1449 (Thorwald Hellner et al. eds., looseleaf 1995).

98. A share pledge may be used to secure future obligations or obligations which are subject to a suspensive condition. §§ 1273 subsec. 2, 1204 subsec. 2 BGB.

99. Benckendorff, *supra* note 97, at annot. 4/1449; Damrau, § 1252 BGB, in 6 *MÜNCHENER KOMMENTAR*, *supra* note 22, at annot. 4.

100. Peter Bassenge, § 1204 BGB, in *PALANDT*, BGB, *supra* note 15, at annot. 7.

101. *Id.*

102. *Id.*

amend and restate the original credit agreement and not to create a new obligation of the borrower.

Nonetheless, a court may later characterize the refinancing agreement as a novation rather than an amendment of the loan. This may happen, for example, if the new lender group comprises participants other than the original lender group. In that case, the court may further hold that the original share pledge has expired as a consequence of the termination of the original loan agreement.

In order to prevent the lender group from losing its security interest in the shares in connection with the refinancing of the loan, it is generally useful to terminate the original share pledge agreement and to replace it with a new share pledge. The disadvantage of terminating the original share pledge agreement and creating a new share pledge is, however, that the new share pledge would rank behind other pledges which may have been granted with respect to the shares in the meantime.¹⁰³ As mentioned above, German law does not allow the parties to maintain the rank of the original share pledge for the new share pledge¹⁰⁴ and it does not provide for a bona fide acquisition of a specific rank.¹⁰⁵ Therefore, the termination of the original share pledge and the creation of a new pledge are only useful if it can be ascertained that no other share pledge has been granted to a third party in the meantime. In any case, the pledgor should be asked to represent and warrant again in the new share pledge agreement that the shares are free of any preexisting encumbrances.

C. RULES ON EQUITY-REPLACING SHAREHOLDER LOANS

Other kinds of serious pitfalls may result from the rules of the German GmbH-Act on the so-called equity-replacing shareholder loans (*eigenkapitalersetzende Darlehen*). In international finance transactions involving the pledge of GmbH shares, these rules may come into play if all or part of the loan is given directly to the German GmbH subsidiary instead of to the U.S. parent company. More specifically, they may apply if additional rights are granted to the pledgee—*e.g.*, by extending the pledge to the pledgor's dividend rights or by granting the pledgee a power of attorney authorizing him to exercise the pledgor's voting rights—thereby assimilating the economic and legal position of the pledgee vis-à-vis the GmbH to that of a shareholder. The following analysis will first briefly summarize the general structure of the rules on equity-replacing shareholder loans and will then discuss their application and consequences in the context of a share pledge.

In essence, the rules on equity-replacing shareholder loans assimilate the legal treatment of loans provided by shareholders to a GmbH to that of share capital in certain financial crisis situations. Generally, loans provided to a GmbH by

103. *Id.*

104. *Id.*

105. Damrau, § 1273 *BGB*, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 7.

its shareholders are treated like any other third party loan. Therefore, the shareholders can usually require repayment of the loan when due and they receive the same treatment as any other creditor if the GmbH goes bankrupt. This equal treatment of shareholder loans and third party loans does not apply, however, if the shareholder loans have to be considered "equity-replacing" shareholder loans. The GmbH-Act defines a shareholder loan as equity-replacing if it is made by the shareholder at a time when shareholders acting as orderly merchants instead would have provided share capital to the company.¹⁰⁶ The determinative criterion for this purpose is whether the company was unworthy of credit at the time the shareholder loan was granted, *i.e.*, whether it would have been able to obtain the loan from an unrelated third party under market conditions.¹⁰⁷

If a shareholder loan is considered equity-replacing, its repayment is subject to important restrictions. For example, the shareholder cannot demand repayment of such loan during bankruptcy proceedings.¹⁰⁸ Instead, the loan is treated as share capital so that satisfaction of all other creditors has priority over its repayment to the shareholder.¹⁰⁹ Further, even outside bankruptcy proceedings, the shareholder is not entitled to demand repayment of the loan if and insofar as the repayment would decrease the company's net worth below its stated share capital. Any repayment made in violation of these rules can be reclaimed from the shareholder.¹¹⁰

The rules on equity-replacing shareholder loans may also apply to loans provided by third party lenders to whom shares of the GmbH have been pledged as collateral for the loan if "from a business perspective these loans resemble shareholder loans."¹¹¹ Under this condition, these rules may therefore also apply to international syndicated loans secured by a share pledge to the extent that all or part of the loan has been granted directly to the German GmbH subsidiary. The vagueness of the above provision makes it of course difficult to apply in legal practice. This uncertainty has only been partially alleviated by a recent

106. § 32a subsec. 1 cl. 1 GmbHG.

107. Götz Hueck, § 32a GmbHG, in BAUMBACH & HUECK, *supra* note 1, at annot. 43; Karsten Schmidt, §§ 32a, 32b GmbHG, in SCHOLZ, *supra* note 40, at annot. 35. The concept of equity-replacing loans does not only apply to loans that are made when orderly shareholders would have provided share capital, but also to loans made before the company's financial crisis which are *extended* in spite of the deteriorated financial situation. See Götz Hueck, § 32a GmbHG, in BAUMBACH & HUECK, *supra* note 1, at annot. 34-40; Karsten Schmidt, §§ 32a, 32b GmbHG, in SCHOLZ, *supra* note 40, at annot. 43-48.

108. § 32a subsec. 1 cl. 1 GmbHG.

109. See Karsten Schmidt, §§ 32a, 32b GmbHG, in SCHOLZ, *supra* note 40, at annot. 53.

110. See §§ 30-31 GmbHG; Götz Hueck, § 32a GmbHG, in BAUMBACH & HUECK, *supra* note 1, at annot. 72-78; Karsten Schmidt, §§ 32a, 32b GmbHG, in SCHOLZ, *supra* note 40, at annot. 76-84.

111. § 32a subsec. 3 GmbHG. See Götz Hueck, § 32a GmbHG, in BAUMBACH & HUECK, *supra* note 1, at annot. 21; Karsten Schmidt, §§ 32a, 32b GmbHG, in SCHOLZ, *supra* note 40, at annot. 123.

decision of the German Federal Supreme Court in Civil Matters.¹¹² It held that the rules on equity-replacing shareholder loans apply to a loan given by a third party lender to whom shares of the GmbH have been pledged as collateral for the loan if, in addition to the share pledge, special rights have been granted to the lender which assimilate his legal and economic position vis-à-vis the GmbH to that of a shareholder.¹¹³

Unfortunately, the court did not state specifically what kinds of special rights granted to the pledgee would trigger the application of the rules on equity-replacing shareholder loans. The court rather based its decision on an overall view of all relevant facts of the case and held that various elements taken together had caused it to conclude that in that specific case the pledgee had in fact acquired a position equivalent to that of a shareholder.¹¹⁴ However, the court provided at least some certainty for the future legal practice by creating a safe harbor rule. Under this safe harbor rule, the rules on equity-replacing shareholder loans are not applicable as long as the security right granted to the lender is limited to a pure share pledge that does not include any dividend rights or other special rights. In that case, according to the court, the rules on equity-replacing shareholder loans would not apply even if the security agreement contractually binds the pledgor not to take any action which may be harmful to the pledged shares, as long as the pledgor himself remains solely entitled to exercise the voting rights and other participation rights attached to the pledged shares.¹¹⁵

In order to prevent the application of the rules on equity-replacing shareholder loans to international finance transactions in which all or part of the loan is given directly to the GmbH subsidiary, it is advisable to draft the share pledge along the lines of the above safe harbor rule. For that purpose, the share pledge agreement should contain neither a pledge of the dividend rights or of other special rights, nor a grant of a power of attorney to the pledgee with regard to the pledgor's voting rights, nor any other provision in the security agreement

112. See Judgment of July 13, 1992, BGH, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] 1300 (1992). Although this decision actually concerned a limited partnership (Kommanditgesellschaft—KG) the sole general partner of which was a GmbH (this kind of corporate entity being commonly called GmbH & Co. KG), its holding also applies to a pure GmbH. See Karsten Schmidt, §§ 32a, 32b GmbHG, in SCHOLZ, *supra* note 40, at annot. 123. See also Holger Altmeppen, *Der "atypische Pfandgläubiger" ein neuer Fall des kapitalersetzenden Darlehens?*, ZIP 1677 (1993); Meinrad Dreher, *Pfandrechtsgläubiger von Geschäftsanteilen als gesellschaftsähnliche Dritte im Sinne von § 32a Abs. 3 GmbHG*, ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 144 (1994).

113. Judgment of July 13, 1992, BGH, *supra* note 112, at 1302.

114. *Id.* These elements included, among others: (i) the pledge and assignment of the dividend rights and other special rights in favor of the pledgee; (ii) a clause in the security agreement providing that the GmbH and its shareholders had to obtain the consent of the pledgee for all important decisions regarding the business management of the security agreement providing that the GmbH and its shareholders had to obtain the consent of the pledgee for all important decisions regarding the business management of the GmbH; and (iii) the fact that the pledgee had subsequently acquired and exercised an influence over the business management which was similar to that of a shareholder. *Id.*

115. *Id.* at 1301; Dreher, *supra* note 112, at 151.

that gives the pledgee control over the business management of the GmbH. Although this would certainly limit the economic value of the share pledge for the lender, it would avoid the severe restrictions to enforce the loan.

IV. Mechanics

The grant of a share pledge raises a number of procedural questions which, although of high practical relevance for international finance transactions, may be unfamiliar to many foreign practitioners.

A. NOTARIZATION

1. *In General*

Under German law, the share pledge agreement has to be notarized in the form of a notarial deed.¹¹⁶ The role of the notary public in the German legal system differs strongly from that of a notary public in Anglo-American jurisdictions. The German notary is a fully trained legal professional whose functions include the authentication of signatures as well as the preparation and notarization of legal documents. During the notarization proceeding, the notary has the duty to provide impartial legal advice to the parties about the legal implications of the documents presented to him for notarization purposes.¹¹⁷ Further, any document to be notarized must be read aloud to the parties appearing before the notary to ensure that they are aware of its contents and its legal implications.¹¹⁸ Contrary to their right to receive legal advice by the notary,¹¹⁹ this latter procedural requirement cannot be waived by the parties.¹²⁰ These procedural rules also apply to the notarization of a share pledge.¹²¹ The share pledge agreement further has to be signed at notarization by the pledgor and the pledgee,¹²² each of whom may be represented by a holder of a power of attorney.¹²³ Any violation of these form requirements makes the share pledge null and void.¹²⁴

With respect to this notarization requirement, two different issues regularly arise in the context of share pledges in international finance transactions. The first issue is whether the notarization requirement applies not only to the share pledge as such, but also to the credit agreement embodying the obligations secured

116. § 1274 subsec. 1 cl. 1 BGB, § 15 subsec. 3 cl. 1 GmbHG.

117. See BEURKUNDUNGSGESETZ [BEURKG] (Notarization Act) §§ 17-21.

118. See §§ 13-16 BEURKG.

119. See § 17 subsec. 1 and 2 BEURKG.

120. See § 13 subsec. 1 BEURKG.

121. See § 1274 subsec. 1 cl. 1 BGB, § 15 subsec. 3 cl. 1 GmbHG.

122. Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 39; Jürg Zutt, *§ 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 92.

123. This power of attorney can be in simple writing form. See Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 39; Jürg Zutt, *§ 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 54 and 92.

124. See § 125 cl. 1 BGB.

by the share pledge. The second issue is whether the notarization requirement can also be satisfied by having the share pledge notarized by a foreign notary outside Germany. As to both issues, the established German legal practice may be about to change in a way that could significantly affect international finance transactions.

2. *Technique of Notarial Deed*

Currently, it is uncertain under German law whether the notarization requirement applies to the share pledge as well as the credit agreement embodying the secured obligations.¹²⁵ Therefore, until recently, it has been a common practice among German notaries to include the credit agreement in the notarization procedure, this being considered the safest method to avoid the potential invalidity of the share pledge agreement due to incomplete notarization.¹²⁶ Particularly in crossborder finance transactions involving extensive legal documentation, this procedure is very time-consuming since it requires the entire credit agreement with all its attachments, often extending over several hundred pages, to be read aloud during the notarization proceeding.¹²⁷

Because of the growing discontent with this cumbersome routine among business clients and legal counsel, some German notaries lately have begun to exclude the credit agreement from the notarization procedure.¹²⁸ This new practice has been supported by several legal practitioners who have convincingly argued in recent law review articles why German law does not necessitate the credit agreement to be included in the notarization.¹²⁹ Their main argument is that the statutory provision calling for the notarization of the share pledge agreement¹³⁰ does not require the secured obligation to be recounted in all detail, but only that it requires the share pledge agreement to describe the secured obligation to the degree that this obligation is identifiable.¹³¹ Otherwise, these authors persuasively argue, it would hardly be possible to grant a share pledge securing a future obligation¹³² which, after all, is expressly permitted under German statutory law.¹³³ Therefore, they conclude that, as long as the share pledge agreement itself

125. This uncertainty is also due the fact that no court has decided on this issue yet. See Martin Heidenhain, *Umfang der Beurkundungspflicht bei der Verpfändung von GmbH-Geschäftsanteilen*, GMBHR 275 (1996).

126. *Id.*

127. *Id.*; Harald Jung, *Pflicht zur Mitbeurkundung der zu sichernden Forderungen bei der notariellen Verpfändung von GmbH-Geschäftsanteilen*, in FREUNDES- UND FESTGABE FÜR KONRAD WERNICKE ZUM 90. GEBURTSTAG, 89-90 (Peltzer & Riesenkampff, Rechtsanwälte eds., 1995).

128. Jung, *supra* note 127, at 90.

129. See Heidenhain, *supra* note 125, at 275; Jung, *supra* note 127, at 89; see also Kolkman, *supra* note 6, at 14.

130. See § 1274 subsec. 1 cl. 1 BGB, § 15 subsec. 3 cl. 1 GmbHG.

131. Heidenhain, *supra* note 125, at 276; Kolkman, *supra* note 6, at 14.

132. Heidenhain, *supra* note 125, at 276; Kolkman, *supra* note 6, at 14.

133. See §§ 1204 subsec. 2, 1274 subsec. 2 BGB.

sufficiently describes the secured obligation, the credit agreement embodying this obligation does not have to be included in the notarization.¹³⁴

However, under this new approach, careful attention has to be paid to the use of references in the share pledge agreement to the credit agreement or the use of terms therein which are only defined in the credit agreement (e.g., description of parties, events of defaults, terms of payment, etc.). The share pledge agreement must be comprehensible by itself. If it is comprehensible only in connection with other documents to which it refers either by explicit reference or by the use of terms defined therein, these documents must be notarized as well.¹³⁵ Otherwise, the share pledge would be null and void. Therefore, if the notarization is to be limited to the share pledge agreement without the credit agreement, the use of such references must be avoided.

3. Notarization Outside Germany

A further question is whether the notarization requirement may also be satisfied by having the share pledge notarized by a foreign notary outside Germany. This question is of great practical importance because the German notarization fees are significantly higher than those in other European countries. Therefore, business clients often prefer to have their legal transactions notarized by notaries in German-speaking neighbor countries with similar legal traditions and fully trained professional notaries, such as Switzerland and Austria.¹³⁶

This question leads to the conflict-of-laws issue of what law applies to the formal validity of a share pledge. The answer is highly disputed in German law. Several commentators argue that this decision has to be made on the basis of the general rule of German conflict-of-laws that determines the law applicable to the formal validity of legal transactions.¹³⁷ Under this rule, the formal validity of a legal transaction is governed alternatively by the law governing the substantive validity of the transaction or the law of the place where the transaction is executed.¹³⁸ The transaction is therefore formally valid if it meets the form require-

134. Heidenhain, *supra* note 125, at 276; Kolkmann, *supra* note 6, at 14.

135. This follows from the purpose of § 9 subsec. 1 cl. 2 BEURKG, which is to guarantee that the meaning of a notarial deed—even if it refers to other documents—can be ascertained at any time. See Judgment of May 18, 1984, OLG Düsseldorf, DEUTSCHE NOTAR-ZEITSCHRIFT 626 (1985).

136. See Joachim Schervier, *Beurkundung GmbH-rechtlicher Vorgänge im Ausland*, 45 NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 593 (1992); Wulf Goette, *Auslandsbeurkundungen im Kapitalgesellschaftsrecht*, DEUTSCHES STEUERRECHT 709 (1996) [hereinafter Goette, *Auslandsbeurkundungen*]; Wulf Goette, *Auslandsbeurkundungen im Kapitalgesellschaftsrecht*, in VERANTWORTUNG UND GESTALTUNG, FESTSCHRIFT FÜR KARLHEINZ BOUJONG ZUM 65. GEBURTSTAG, 131 (Carsten Thomas Ebenroth et al. eds., 1996).

137. See Jürg Zutt, § 15 GmbHG, in HACHENBURG, *supra* note 47, at annot. 59; Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 39; Andreas Heldrich, *Art. 11 EGBGB*, in PALANDT, BGB, *supra* note 15, at annot. 13; Heinz Winter, § 15 GmbHG, in SCHOLZ, *supra* note 40, at annot. 39 and 155.

138. See art. 11 subsec. 1 EINFÜHRUNGSGESETZ ZUM BÜRGERLICHEN GESETZBUCH [EGBGB] (Introductory Code to the German Civil Code).

ments of either one of these laws. According to German conflict-of-laws, the substantive validity of the pledge of shares of a GmbH that has its main place of business in Germany is German law.¹³⁹ The place of the execution of the share pledge may be a place outside Germany. Consequently, the share pledge becomes effective if it meets either the German form requirements or the form requirements of the foreign law where the share pledge is executed. Therefore, under this rule, the notarization by a foreign notary observing the local rules at the place of notarization would suffice to make the share pledge formally valid.

However, it is rather uncertain, and has become even more so recently, whether the above conflict-of-laws rule is actually applicable to the pledge of GmbH shares or to other corporate legal transactions which require notarization under German law (e.g., execution of incorporation deed, amendment of articles of association, etc.). Several commentators argue that these transactions always have to meet the German notarization requirement and therefore cannot be notarized by a foreign notary.¹⁴⁰ A leading case decided by the German Federal Supreme Court in Civil Matters in 1981, on the other hand, appeared to favor the application of the above conflict-of-laws rule in this context.¹⁴¹ But the court ultimately left this issue undecided by holding that, even if the German notarization requirement were applicable to such transactions when executed outside Germany, it could still be met by the notarization by a foreign notary as long as the role of the foreign notary and the procedure of notarization under the respective foreign legal system are equivalent to their German counterparts. The court decided that such equivalence existed with regard to the notarization by a Swiss notary in Zurich.¹⁴² Under this case, it has therefore become a relatively common practice in the German business community to have corporate legal transactions that require notarization under German law be notarized by Zurich notaries.

Yet, a law review article published recently by a member of the Federal Supreme Court has put the continuing standing of this case into doubt.¹⁴³ This article follows several German commentators¹⁴⁴ who maintain that such corporate legal transactions, which relate to the structure of the company, such as the incorpora-

139. See Carsten Thomas Ebenroth, *Nach Art. 10 EGBGB*, in 7 MÜNCHENER KOMMENTAR, *supra* note 12, at annot. 307; KEGEL, *supra* note 12, at 414-15.

140. See Schervier, *supra* note 136, at 598; Großfeld, *Internationales Gesellschaftsrecht*, *supra* note 12, at annot. 427; Karl Winkler, *Beurkundungen im Ausland bei Geltung deutschen Rechts*, 25 NJW 981, 982 (1972); see also Bernhard Großfeld & Joachim Berndt, *Die Übertragung von deutschen GmbH-Anteilen im Ausland*, 42 RECHT DER INTERNATIONALEN WIRTSCHAFT [RIW] 625, 630 (1996).

141. Judgment of February 16, 1981, BGHZ, 80 ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFES IN ZIVILSACHEN 76. The court confirmed its opinion in a later case; see Judgment of May 22, 1989, BGH, 35 RIW 649 (1989).

142. Judgment of February 16, 1981, BGH, *supra* note 141.

143. Goette, *Auslandsbeurkundungen*, *supra* note 136, at 709.

144. See Götz Hueck, § 2 GmbHG, in BAUMBACH & HUECK, *supra* note 1, at annot. 9; Harm P. Westermann, *Einleitung*, in SCHOLZ, *supra* note 40, at annot. 94-95; Hans-Joachim Priester, § 53 GmbHG, in SCHOLZ, *supra* note 40, at annot. 72-73; Peter Behrens, *Einleitung*, in HACHENBURG, *supra* note 47, at annot. 160.

tion deed or a change of the articles of association, always have to be notarized by a German notary.¹⁴⁵ Although it is still uncertain whether the Federal Supreme Court will eventually endorse this more restrictive approach,¹⁴⁶ a strong argument can be made that it will not be applicable to the pledge of GmbH shares since such transactions generally do not affect the company's structure.¹⁴⁷ Therefore, it should continue to be possible to have a pledge of GmbH shares notarized by a Zurich (or other Swiss) notary or by notaries in other countries where the notarization procedure and the legal status of the notary are equivalent to German law. On the other hand, cautious German counsel may still point out the remaining uncertainties and therefore recommend notarization before a German notary.

B. NOTIFICATION OF COMPANY AND ADDITIONAL REQUIREMENTS PURSUANT TO ARTICLES OF ASSOCIATION

Unless otherwise provided in the company's articles of association, the company whose shares are pledged does not need to be notified about the pledge in order for it to become effective as between the parties of the pledge agreement and vis-à-vis third parties.¹⁴⁸ Nonetheless, it is a useful and common practice to notify the company about the share pledge because as a consequence of the notification, solely the pledgee will be authorized to claim any payments from the company which were originally due to the pledgor and to which the pledgee has become entitled under the share pledge agreement (*e.g.*, dividend rights and rights to liquidation proceeds).¹⁴⁹

Besides notification of the company, the articles of association may provide further conditions for the share pledge to become effective, such as the consent

145. The article argues that transactions pertaining to the structure of the company need to be reviewed as to their legal implications by the notary from the perspective of a disinterested third party because such transactions usually also affect the interests of third parties who are not present at notarization. Since the review of the transaction would require a thorough knowledge of the substantive German law which a foreign notary normally does not possess, the notarization by a foreign notary would not suffice to fulfill the German notarization requirement. Goette, *Auslandsbeurkundungen*, *supra* note 136, at 713.

146. The above article has already been cited with approval by a lower court which held that the notarization of a merger agreement between two German limited liability companies by a Swiss notary in Zurich would not satisfy the German notarization requirement; see Judgment of June 4, 1996, LG Augsburg, *DER BETRIEB* 1666 (1996). This decision has caused great uncertainty and anxiety in the German legal and business community because it threatens the validity of many corporate transactions which were notarized outside Germany for cost saving reasons; see *Große Rechtsunsicherheit bei Beurkundungen im Ausland*, *HANDELSBLATT* (Düsseldorf/Frankfurt a. M.), August 15, 1996.

147. See Goette, *Auslandsbeurkundungen*, *supra* note 136, at 713.

148. Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 155; Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 42; Damrau, § 1274 *BGB*, in 6 *MÜNCHENER KOMMENTAR*, *supra* note 22, at annot. 55.

149. See § 16 subsec. 1 *GmbHG*; Damrau, § 1274 *BGB*, in 6 *MÜNCHENER KOMMENTAR*, *supra* note 22, at annot. 55; Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 155; Kolkmann, *supra* note 6, at 15.

of the company¹⁵⁰ or the delivery of certificates for the pledged shares, if such certificates were issued,¹⁵¹ by the pledgor to the pledgee.¹⁵² Finally, the articles of association may also totally prohibit a share pledge. In that case, a pledge of the company's shares would be null and void.¹⁵³

C. LEGAL OPINION

In the context of international finance transactions, it is customary that a legal opinion is provided by German legal counsel with respect to the share pledge. Usually, the legal opinion is furnished by borrower's counsel. But there are also good reasons for having the legal opinion provided by lender's counsel.

In the legal opinion, German counsel customarily states that the GmbH whose shares are pledged is duly incorporated and validly existing under German law, that the pledge agreement has been duly notarized and executed, that it constitutes a valid and binding pledge agreement enforceable under the articles of association of the GmbH and statutory German law, and that the agreement by its terms is effective to create a valid and enforceable lien on the pledged shares in favor of the pledgee. However, since German law provides neither for a registration of the share pledge nor for a bona fide creation or rank of the pledge,¹⁵⁴ German counsel cannot give an opinion as to whether the pledgor validly holds the pledged shares or whether the pledge will have the anticipated rank position. Finally, German counsel customarily states in the legal opinion that the lenders and their agent do not become domiciled or subject to taxation in Germany by reason of the execution, performance, or enforcement of the share pledge and that a judgment obtained against the borrower for the recovery of claims due under the credit agreement is enforceable in Germany in accordance with § 328 of the German Code on Civil Procedure (*Zivilprozeßordnung*—ZPO).¹⁵⁵

150. Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 154; Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 41.

151. Since the GmbH is designed under German statutory law as a close corporation with few shareholders with its shares being only rarely transferred, the company is not required to, and usually does not, issue share certificates for its shares. However, such certificates may be issued if the shareholders so decide. See Heinz Winter, § 14 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 64.

152. Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 154; Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 41. *Contra*: Kolkmann, *supra* note 6, at 15.

153. Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 154; Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, at annot. 41.

154. See *supra* part IIIA.

155. Under § 328 ZPO a foreign judgment is enforceable in Germany if it meets the following conditions: (i) the court that rendered the foreign judgment had international jurisdiction over the case under German rules of civil procedure; (ii) the defendant was properly notified of the proceeding leading to the foreign judgment and was given an opportunity to be heard; (iii) the foreign judgment does not run counter to a prior German or foreign judgment or a pending litigation in Germany; (iv) the foreign judgment does not violate German public policy; and (v) "reciprocity" is guaranteed, i.e., a German judgment would be recognized and enforced in the country where the foreign judgment was rendered basically under the same conditions as those applicable to the recognition of the foreign judgment in Germany.

D. PLEDGE OF LESS THAN TWO THIRDS OF SHARES FOR U.S. TAX REASONS

For U.S. tax reasons, U.S. borrowers often prefer to pledge only a specific amount of their shares in the German subsidiary of less than $66\frac{2}{3}\%$ of the total voting power of the GmbH. Otherwise, under U.S. tax law, the pledge of the subsidiary's stock could be deemed a taxable dividend from the German subsidiary to its U.S. parent.¹⁵⁶

German corporate law generally allows this practice as long as certain conditions are met. Since a GmbH usually has a small number of shareholders with each holding only one share, the pledge of an amount close to $66\frac{2}{3}\%$ of the total voting shares may not correspond exactly to the partition of the outstanding shares. Therefore, it may become necessary to pledge one of the outstanding shares only partially in order to attain the desired percentage. Unless the articles of association of the GmbH otherwise provide, such partial pledge is permitted under German law.¹⁵⁷ Yet it requires that the company consent to the partial pledge in writing.¹⁵⁸ It also requires that the German statutory rules on the denomination of GmbH shares are followed. Accordingly, the respective amount of the two parts of the share created by the partial pledge has to be divisible by DM 100 and must not be smaller than DM 500.¹⁵⁹

156. The Internal Revenue Code of 1986 and the U.S. Treasury Department regulations issued thereunder contain various rules that treat certain transactions as taxable dividends paid from a "controlled foreign corporation" (CFC) to its U.S. parent in advance of actual payment (a CFC being any foreign corporation more than 50% owned, by vote or value, by U.S. persons, each of whom owns at least 10% of the CFC). For instance, the U.S. Treasury Department regulations under Section 956(d) of the Internal Revenue Code provide that if a U.S. corporation pledges stock representing at least $66\frac{2}{3}\%$ of the voting power of all stock of a CFC and the CFC is also subjected to negative covenants not to deplete its assets (e.g., prohibition of new CFC debt or sale of the CFC's assets), then the CFC is deemed to have invested in U.S. property in the amount of the unpaid principal on the U.S. parent loan secured by the pledge of the CFC's stock. This deemed investment in U.S. property in turn creates a deemed taxable dividend to the U.S. parent to the extent that the CFC has current or accumulated undistributed tax earnings and profits, determined under U.S. tax principles, at the end of its tax year. In order not to unnecessarily deplete the U.S. borrower's assets for the benefit of the U.S. Treasury, lenders are often persuaded to accept a pledge of less than $66\frac{2}{3}\%$ of the CFC's voting stock. Some lenders prefer to gain more security while avoiding the application of the above rule by forcing a recapitalization of the CFC to create a valuable nonvoting stock, 100% of which can be pledged to the U.S. parent's lenders without triggering the potential deemed dividend. (The above text is based on a memorandum generously provided to the authors by Dale L. Ponikvar, Esq., of Milbank, Tweed, Hadley & McCloy, New York.)

157. Heinz Winter, § 15 *GmbHG*, in SCHOLZ, *supra* note 40, at annot. 157; Jürg Zutt, *Anhang § 15 GmbHG*, in HACHENBURG, *supra* note 47, annot. 39; Damrau, § 1274 *BGB*, in 6 MÜNCHENER KOMMENTAR, *supra* note 22, at annot. 52; Götz Hueck, § 17 *GmbHG*, in BAUMBACH & HUECK, *supra* note 1, at annot. 13.

158. § 1274 subsec. 1 *BGB*, § 17 subsec. 1 and 2 *GmbHG*.

159. See §§ 5 subsec. 1 and 3, 17 subsec. 4 *GmbHG*; Götz Hueck, § 17 *GmbHG*, in BAUMBACH & HUECK, *supra* note 1, at annot. 6-7. If the pledge is realized by way of public auction or private sale, the share becomes separated in the (sold) pledged part and the nonpledged part that continues to vest in the pledgor. Consequently, two shares are created each of which must conform with the above statutory rules on the denomination of GmbH shares. Götz Hueck, § 17 *GmbHG*, in BAUMBACH & HUECK, *supra* note 1, at annot. 6-7.

V. Conclusion

The pledge of GmbH shares is often encountered in international finance transactions involving foreign borrowers with German subsidiaries. Such share pledge regularly confronts the participants of such transactions with certain peculiarities of the applicable German law. If these requirements are not carefully observed, the share pledge may easily become ineffective and its security purpose consequently may be frustrated. The purpose of this article was to point out these issues and to outline strategies on how to deal with them in a manner that safeguards the lender's interests. If these strategies are carefully followed, the pledge of GmbH shares can serve as an important element of the overall collateralization in cross-border finance transactions involving an interest in a German GmbH.

